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IN THIS ISSUE:

Tax Reform Gets Final Diet Approval	1
Takeshita Reshuffles Cabinet	3
Tenor Of Japanese-Soviet Relations Improves	5
Yen Reaches Plateau In 1988	7
Probe Of Japan's Construction Bidding Reveals Rifts	8
AT&T Says Japanese Makers Dumping Telephone Equipment	9

Tax Reform Gets Final Diet Approval

Despite last-minute delaying tactics by opposition parties, the Liberal Democratic Party pushed a controversial tax reform package through the upper house of the Diet December 24, clearing the way for the first significant changes in Japan's tax system in 40 years. Reaction to the changes ranges from positive among business leaders to negative among the general public. Although passage of the tax bills increases the probability of a second term for Prime Minister Noboru Takeshita, he faces a tough task in allaying the concerns of the average taxpayer. Passage of the reforms also clears the way for the government to proceed with budget plans for the coming fiscal year.

The Japan Socialist Party and the Japan Communist Party tried every parliamentary maneuver they could think of to prevent the bills from passing. In addition to proposing a general no-confidence motion against the entire Takeshita cabinet, the JSP and the JCP sought to censure Mr. Takeshita as well as then Home Affairs Minister Seiroku Kajiyama, former Justice Minister Yukio Hayashida and the chairman of the upper house Tax System Committee, Matazo Kajiki. While the outcome of each vote was never in doubt (the LDP controls 60

Yen Reaches Plateau In 1988

A few years ago, some alarm bells would have gone off in Japan if the yen had jumped 12.8 percent on average against the dollar. Yet just that happened in 1988, and few in Japan seemed the slightest bit worried. In fact, corporate profits increased compared to 1987 results, and economic growth accelerated, exactly the opposite of what might have been expected. At the same time, the dollar-denominated current account surplus, which had dropped slowly but unambiguously in response to the previous bouts of yen appreciation, showed signs of stabilizing at a historically high level.

What happened? By 1988 the appreciation of the yen was old hat; compared to the 41.5 percent jump in 1986 and the 16.5 percent rise in 1987, the 1988 increase seemed modest. In 1988, as in previous years, the day of reckoning for Japanese exporters was avoided by a combination of strong economic growth at home, which enabled firms to shift sales from abroad to the domestic market, and stronger than expected growth abroad, which limited the loss of overseas markets. The ability of Japanese firms to cut costs at home and their willingness to accept limited dollar export price increases also were factors. With domestic growth expected to be strong for the immediate future, Japanese firms remain confident, even if the yen rises further.

The yen's appreciation in 1988 continued to show a pattern of stable periods interspersed with periods of sharp movement (see Table). Recovering from a high of Y120.45=\$1.00 on the Tokyo market in early January, the yen ended January at Y127.18=\$1.00. Little movement occurred until the summer when the dollar staged a modest rally that lasted several months. Some analysts who a few months earlier had foreseen nothing but gloom for the American currency became unbridled optimists. But before long they were proven wrong for the second time when the dollar resumed its downward path, picking up speed after the U.S. elections in November. The dollar closed the year at Y125.9 after having resisted the Y120 barrier in late November for the second time in 1988. For all the yen's ups and downs, it was stronger every month last year than in the same month of 1987.

Table 1: Yen-Dollar Exchange Rate, 1983-88

(monthly average, Tokyo's interbank market)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
January	Y232.9	Y234.0	Y254.1	Y200.0	Y154.5	Y127.6
February	236.3	233.7	260.3	184.6	153.5	129.2
March	237.9	225.5	258.4	178.8	151.5	127.3
April	237.7	225.0	251.7	175.6	143.0	125.0
May	234.8	230.7	251.6	166.9	140.5	124.8
June	240.1	233.3	249.0	167.8	144.5	127.1
July	240.5	242.7	241.7	158.7	150.2	133.1
August	244.4	242.2	237.2	154.1	147.6	133.6
September	242.7	245.2	236.9	154.8	143.0	134.4
October	233.0	246.9	214.8	156.0	143.5	129.0
November	235.3	243.3	203.9	162.7	135.3	123.2
December	234.3	248.0	202.8	162.1	128.4	123.6
Annual Average	237.5	237.5	238.5	168.5	144.6	128.2

Will this pattern repeat itself in 1989? Higher interest and inflation rates in the United States than in Japan, as well as the staggering current account imbalances in both countries, point to further yen appreciation this year, although, as in the past, market psychology will play a critical role. While the year is unlikely to see the arrival of the long-awaited 100-yen dollar, a new postwar high for the yen in the Y110 to Y120 range can be expected.

The currency markets always keep at least one eye on Washington, but this year American policymakers will get even more attention than usual. Despite the assurances of incoming Bush administration officials, market participants may be less than completely convinced of Washington's commitment to international policy coordination and exchange rate stabilization efforts. Even if those commitments are genuine, they may mean little if the Bush administration and the Congress prove unable to rein in the U.S. federal budget deficit, which creates large and potentially destabilizing capital inflows into the United States.

Regardless of how events in Washington work themselves out, the currency market in late 1988 contained a positive omen concerning future capital inflows. Since at least 1985, when the yen began its sustained rise, using yen to invest in dollar-denominated securities has proven almost a guaranteed way to lose money. The loss in yen terms has more than offset the interest rate advantage of dollar-denominated instruments. It comes as no surprise that private foreign investors have shown increasing reluctance to bet on dollar securities. But the time may have come to rethink this position. By December 1988 the exchange rate change had slowed to the point where the overall year-to-year return on many comparable yen and dollar investments were virtually equal. If the dollar's relative stability holds, U.S. instruments could become increasingly attractive. In this virtuous cycle, the dollar would in turn gain greater strength. Dollar investments would be profitable and the corresponding capital inflow sustainable in the face of a modest, ongoing appreciation of the yen. Slow appreciation is exactly what most analysts expect of the yen over the next year.

Douglas Ostrom

Probe Of Japan's Construction Bidding Reveals Rifts

An investigation by the Office of the U.S. Trade Representative into Japan's construction bidding procedures is revealing some interesting testimony. The investigation, under Section 302 of the 1974 Trade Act, was mandated as part of the 1988 Omnibus Trade and Competitiveness Act (see JEI Report No. 45B, December 2, 1988). Foreign access to Japan's construction market has become a highly visible issue as the value of the Japanese market has climbed to an estimated \$300 billion, second only to the \$400 billion U.S. market.

Since the United States and Japan had signed a March 1988 agreement covering bidding procedures for 14 public works projects (see JEI Report No. 13B, April 1, 1988), the Japan Federation of Construction Contractors and Ministry of Construction officials expected USTR's investigation to be pro forma. In a letter to USTR, JFCC contended that Japan's system of designated bidders is "nondiscriminatory and open to foreign companies." Furthermore, JFCC feels that the U.S.-Japan construction pact is "fair and reasonable."